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IMPRESSION MANAGEMENT STRATEGIES IN THE LETTER TO SHAREHOLDERS: EMPIRICAL EVIDENCE FROM ITALIAN LISTED FIRMS*

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ABSTRACT

The importance of the Letter to Shareholders (LS) as a form of corporate communication is well documented in the previous literature. However, existent contributions also suggest that LS are used opportunistically by firms as locus of Impression Management (IM) strategy, possibly because of their voluntary and unregulated nature. The aim of this study is to assess whatever Italian firms use LS to convey a manipulated view of firms' behaviour. In particular, the paper verifies if unprofitable firms adopt a biased language in the LS manipulating the textual characteristics of these letters. A manual content analysis and a multivariate statistical analysis are run analysing the disclosure offered in all the LS made available by Italian listed firms referring to year 2013. The key results show that firms tend to use biased language to obfuscate their weak achievements, thus demonstrating that firms adopt IM in their LS. The evidence has relevant implications as we show that LS cannot be considered informative but rather than as a communication strategy to advance corporate image.

Keywords: *letter to shareholders, impression management, textual characteristics, disclosure strategy, managerial opportunism, content analysis, Italy.*

INTRODUCTION

The Letter to Shareholders (LS) is achieving an increasing importance as a fundamental component of corporate reports (Clatworthy and Jones, 2006); previous studies demonstrate that the LS is the most read part of the annual report (Barlett and Chandler, 1997; Epstein and Pava, 1993). Its importance is ascribed to the fact that it affects investors' decision making process and is considered useful for the prediction of future performance (Kaplan *et al.*, 1990; Smith and Taffler, 1995; Segars and Kohut, 2001).

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Nevertheless, LS is not usually subject to regulation and the role of the auditor is limited to the assessment that the information reported is consistent with the values presented in the financial statements, in that allowing managers to have high discretion in selecting and presenting the information by mean of LS (Hoogiemstra, 2010). As underlined by Baker and Bettner (1997, p. 305), LS "may not produce an objective presentation of the economic reality but rather a highly contested and partisan representation of social and economic world".

It is thus not surprising that firms use LS opportunistically, offering disclosure that is biased: on the one hand, these letters are a powerful vehicle to inform outsiders; on the other hand, they allow firms to behave in a self-serving way, as managers are not much concerned with regulatory repercussions (Hoogiemstra, 2010).

Previous studies provide evidence of the presence of the so called Impression Management (IM) strategies in the LS as they demonstrate that managers use LS opportunistically to manipulate audience perceptions of the actual corporate behavior. Most of these studies concentrate on non-European firms (*e.g.* Courtis, 1998; Hoogiemstra, 2010; Patelli and Pedrini, 2014). Among the studies on European firms, Smith and Taffler (2000) and Clathworthy and Jones (2006) demonstrate that UK firms manipulate the disclosure offered in the president letters, whilst Aerts (1994 and 2005) analyses Belgian firms. It appears that there is a lack of studies that consider the LS of Italian firms. Therefore, the objective of this paper is to fill this gap by examining whether Italian firm adopt IM strategies in their LS.

Drawing on previous studies on the use of IM in the LS, we perform a manual content analysis of all the LS of Italian listed firms available for year 2013, assessing the textual characteristics of the disclosure that previous studies considered symptomatic of the use of IM (Clathworthy and Jones, 2006) and build an IM index apt to capture the level of bias of the LS disclosure. Subsequently, we assess the association between the IM index and firms characteristics that provide managers with incentives to manipulate disclosure. In particular, we focus on the presence of a negative performance consistently with the idea that managers are particularly prompt to adopt IM strategy opportunistically when their achievements are weak (Clathworthy and Jones, 2003 and 2006; Schleicher and Walker, 2010).

The rest of the paper is articulated as follow: in the next section we present the theoretical background of the study and develop the research hypothesis; in the third section we explain the research design, whilst in the fourth one we present and discuss the results. Finally, the last section highlights the contributions and limitations of the research.

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THEORETICAL BACKGROUND AND HYPOTHESES DEVELOPMENT

IM is defined as the process by which individuals attempt to influence the impression of other subjects to portray a positive image of themselves (Leary and Kowalski, 1990). IM originates in the psychological literature but there is extensive evidence of the adoption of IM strategies in the context of corporate reporting: companies tend to use disclosure opportunistically by presenting their performance in a "biased" manner (Merkel-Davies and Brennan, 2007).

Previous studies provide evidence of the adoption IM in different form of corporate reporting (*e.g.* annual reports and sustainability reports). An increasing number of studies are focusing their attention specifically in the LS: indeed, in light of its voluntary and unregulated nature LS creates a unique possibility for managers to manipulate the impression that investors have of the company (Hoogiemstra, 2010).

IM strategies are linked to firm performance. Previous studies show that firms adopt IM strategies by demonstrating that firms with bad economic results use biased language in their LS (Kohut and Segars, 1992; Clarke, 1997; Thomas, 1997; Syderff and Weetman, 2002; Clathworthy and Jones, 2003; Patelli and Pedrini, 2014). This argument is grounded on the idea that the weaker the firm performance, the higher the managers' incentives to use biased language to make up for their poor achievements. Motivated by all these aspects we test the following research hypothesis:

Hp 1: Unprofitable firms have significantly higher level of disclosure bias.

As explained in the next section, the disclosure bias is defined with reference to six textual characteristics of the information that previous literature considered symptomatic of IM strategies (Clathworthy and Jones, 2006). These textual characteristics refer both to syntactical measures (proportion of passive sentence and personal references) and to the specific content of the disclosure provided (number of key performance indicators, key financial values, percentages, and forward-looking information).

Previous literature argues that managers of unprofitable firms try to distance themselves from negative performance using passive constructions (Thomas, 1997; Sydserff and Weetman, 2002; Clathworthy and Jones, 2006). Previous studies also argue that managers of profitable companies are more likely to use personal pronouns to show that such performance has been obtained by their work; on the contrary, managers of unprofitable firms avoid using first person pronouns to distance themselves from the bad news (Hyland, 1998; Clathworthy and Jones, 2006).

Additionally, previous literature suggests that, compared to profitable firms, unprofitable ones tend to include in the narrative sections of the annual report less key financial variables (Beattie and Jones, 2000; Clatworthy and Jones, 2006), as well as less quantitative references (Gibbins *et al.*, 1990; Skinner, 1994; Clatworthy and Jones, 2006) to dilute the effect of the bad news. Finally, unprofitable firms try to

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move stakeholders' attention away from unfavourable performance focusing more on the future than on the (unsatisfying) past (Kohut and Segars, 1992; Pava and Epstein, 1993; Clatworthy and Jones, 2006). All together, these five textual characteristics allow the assessment of the extent of disclosure bias in the LS as explained in the next section.

RESEARCH DESIGN

Impression management index

Empirical studies on IM tend to focus on single textual characteristics apt to measure disclosure bias individually, such as the use of passive sentence or personal pronouns. However, previous studies suggest that companies adopt several IM techniques simultaneously, shedding lights on the importance to develop multidimensional measure of disclosure bias (Clathworhy and Jones, 2006). This means that IM behaviour may be better understood and investigated considering the different gimmicks all together, as the willingness of favourably affecting stakeholders judgements may actually encourage the firms to act on multiple aspects of the disclosure provided in the LS.

Therefore, focusing on textual characteristics of the LS already studied by previous literature (Clatworthy and Jones, 2006), we develop a comprehensive IM index (*im_index*) to proxy for six IM techniques that companies may apply. As above mentioned, such an index measure the disclosure bias combining the following textual characteristics: the number of passive sentences (*pass_sent*) and of future sentences (*future_sent*) contained in the LS; the number of personal references (*pers_ref*), the number of key financial indicators (*key_fin*); the number of references to money amounts included in the LS (*money_ref*), *e.g.* absolute value of investments or earnings; the number of quantitative references expressed as a percentage (*perc*), *e.g.* percentages of increase or decrease in sales or earnings.

The *im_index* is designed in such a way that increasing values of the index itself signal that the company disclosure is more biased. To achieve such a purpose, we assign proper signs to individual IM indicators relying on the relationships hypothesized by previous literature on IM. More specifically, we consider *pass_sent* and *future_sent* as being negatively associated with performance. Conversely, we consider *pers_ref*, *key_fin*, *money_ref*, and *perc* as being positively related with performance; therefore, we include in the *im_index_perc* the opposite value (complement to 1) of the selected indicators. Our *im_index* is constructed by summing up said textual characteristics as follows:

$$im\_index = pass\_sent + future\_sent + (1 - pers\_ref) + (1 - key\_fin) + (1 - money\_ref) + (1 - perc)$$

Following the approach by Gordon *et al.* (2009), each IM indicator is standardized among sample firms before being combined in the equation. By means of the standardization technique we obtain variables rescaled to have a mean of 0 and a standard deviation of 1. Such variables may therefore be consistently

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summed up although they were originally measured using different units of reference (number of sentences or number of words). In addition, the resulting index proxies a normal distribution.

Empirical model

We test whether unprofitable firms make use of IM devices (Hp 1) by means of the following multivariate OLS regression model:

$$im\_index_i = \alpha + \beta_1 PERF_i + \beta_2 ls\_lenght_i + \beta_3 size_i + \beta_4 industry_i + \varepsilon$$

As previously stated, our dependent variable *im_index* is a summary of the different kinds of IM gimmicks companies may put in place using textual characteristics. Our test variable *PERF* is a binary variable proxying for company performance and equal to 1 if the company is profitable, and 0 otherwise. Two different measures of performance are considered: in a first model we proxy for performance referring to the Return on Assets ratio (ROA) and construct the binary variable *d_roa*, equal to 1 if ROA is equal to or higher than zero, and 0 otherwise; in a second model we proxy for performance referring to both the ROA and the Return on Equity (ROE) ratios simultaneously and define the binary variable *d_perf*, equal to 1 if both ROA and ROE are equal to or higher the zero, and 0 otherwise.

We include in the model the control variable *ls_lenght*, *i.e.* the LS length measured in number of pages, as previous literature provides mixed evidence on the relation between length and disclosure manipulation (Kohut and Segars, 1992; Clathworthy and Jones, 2006). Finally, we control for the most common variables accounting literature (*e.g.* Cho et *al.*, 2010) suggests to consider when modelling for companies disclosure behaviour: *size*, *i.e.* company size measured as the natural logarithm of market capitalization, and *industry*, *i.e.* the kind of activity run by the company (see Table 1b for details about industry classification).

Sample and data

With the purpose of testing our hypothesis, we focus on the population of non-financial companies listed on the Italian Stock Exchange at the end of 2013. We browse the Investor Relations section of their websites in order to identify the LS to analyse. We consider both the LS included in the Annual Report and the ones forming a separate document. We find 66 LS available.

From each LS we manually collect data linked to IM practices by means of a manual content analysis. Drawing on Clathworhy and Jones (2006), we examine in details each LS counting the total number of pages, sentences and words there included; the number of passive sentences; the number of quantitative statements (*i.e.* monetary references and percentage references); the number of references to financial performance variables (*i.e.* sales, earnings before tax, and dividends); the number of personal references in the text (*i.e.* the Italian equivalent for "I", "me", and "my"); and, finally, the number of words in future oriented sentences.

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The reliability of the classification procedure is assessed following Krippendorff (2013). To check for inter-rater reliability, the different authors have used the specified coding system on the LS of the entire sample and repeated the analysis at different time periods. The coefficient of agreement (*i.e.* the ratio of the number of pairwise interjudge agreements to the total number of pairwise judgments) found is above the acceptance level.

Accounting data referring to each company (namely, ROA and ROE necessary to define our test variables *d_roa* and *d_perf*) are gathered from the AIDA database, while market capitalization at the end of 2013 is downloaded from the Bloomberg database. We rely on the industry classification provided by the Italian Stock Exchange for our control variable *industry*.

Excluding companies with missing data, our final sample consists of 52 observations.

EMPIRICAL RESULTS

Descriptive statistics and correlations

Table 1a presents descriptive financial statistics on our sample. The *im_index* presents a mean equal to 4, but varies significantly among companies. Higher levels of *im_index* mean higher presence of the textual characteristics which may be ascribed to IM strategies. Descriptive statistics for profitability show that 80% of the sampled companies obtain a null or positive operating income (*d_roa*), while 71% are profitable in terms of both operating and net performance (*d_perf*). The length of LS (*ls_lenght*) is on overage around 2 pages, but varies significantly within the sample. Finally, companies' size is quite different as well. As shown by Table 1b, sampled companies pertain to different fields of activity.

Variable	Obs	Mean	Std. Dev.	Min	Max
im_index	52	4	1.939205	-.8505091	10.20916
d_roa	52	.8076923	.3979586	0	1
d_perf	52	.7115385	.457467	0	1
ls_lenght	52	2.153846	1.460387	.5	9
size	52	6.840255	1.938236	2.823163	11.05977

Table 1a. *Summary of the descriptive statistics*

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industry		Freq.	Percent	Cum.
Utilities	1	9	17.31	17.31
I&C Tech	2	8	15.38	32.69
Consumer goods	3	10	19.23	51.92
Industrials	4	15	28.85	80.77
Health care	5	4	7.69	88.46
Consumer services	6	1	1.92	90.38
Oil, gas, basic materials	7	5	9.62	100.00
	Total	52	100.00	

Table 1b. *Distribution of observations by industry*

The correlation matrix presented in Table 2 shows a negative and significant association between *im_index* and both our performance measures (*d_roa* and *d_perf*), as expected. Such performance measures are also positively associated with *size*, signalling that bigger companies present a higher probability of reaching positive performances than smaller firms.

Also, Table 2 shows that, for each of the variables, the Variance Inflation Factor (VIF) is smaller than the threshold value "3", indicating that multicollinearity would not affect the results.

	im_index	*d_roa*	*d_perf*	*ls_lenght*	*size*	VIF
im_index	1.0000					
d_roa	-0.3339*	1.0000				2.86
d_perf	-0.2921*	0.7664*	1.0000			2.69
ls_lenght	-0.2207	-0.1674	-0.0643	1.0000		1.18
size	0.0149	0.4051*	0.2744*	0.0902	1.0000	1.37
industry	(omitted)	(omitted)	(omitted)	(omitted)	(omitted)	(omitted)

Table 2. *Matrix of correlations and variance inflation factor*

* indicates significance at 5% level; Mean VIF = 1.83

Multivariate results

In a multivariate analysis, we examine whether firm performance is associated with the level of disclosure bias (measure by mean of the *im_index*) also controlling for some variables previous research suggests being related with the latter. Table 3 presents the results. More specifically, Column 1 presents results obtained splitting the sample in profitable and unprofitable firms using *d_roa* as a reference, while Column 2 presents results obtained using *d_perf* as a discriminating factor.

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	(1) *im_index*	(2) *im_index*
d_roa	-2.4061*** (0.7645)	
d_perf		-1.4995** (0.6783)
ls_lenght	-0.3989** (0.1917)	-0.3050 (0.1971)
size	0.2301 (0.1548)	0.1201 (0.1550)
industry	(omitted)	(omitted)
_cons	5.0167*** (1.4393)	4.7133*** (1.5267)
N	52	52
R^2	0.2546	0.1749
F	1.5944	0.9889

Table 3. *The relation between firm's performance and overall impression management practices*

Standard errors in parentheses; * p<0.1, ** p<0.05, *** p<0.01

Consistently with our expectations, we find a negative and significant association between firm performance and the extent of IM gimmicks activated in the LS. Indeed, *beta* coefficients of our test variables, expressing alternatively firm operating performance (*d_roa*) and overall performance (*d_perf*), are both negative and significant (p<0.01 for *d_roa*, p<0.05 for *d_perf*). These results clearly indicate that unprofitable companies use a significantly different extent of IM "adjustments" in their LS than profitable companies. More specifically, we demonstrate that when firms are unprofitable they record a significantly higher *im_index*, consistently with the idea that managers manipulate the disclosure offered in the LS to detract attention from their bad achievements.

Additional tests

Having found support to our Hp 1 considering overall IM practices as summarized in a single and innovative IM index, we run a number of additional tests in order to verify which kinds of IM techniques unprofitable companies use to divert stakeholders' attention to aspects different from the unsatisfying performance itself.

To such an extent, we run 12 additional regression models, *i.e.* one regression model for each of the variables forming our *im_index* (*pass_sent*, *future_sent*, *pers_ref*, *key_fin*, *money_ref*, and *perc*) and for each of the test variables previously discussed (*d_roa* and *d_perf*). In order to compare consistently such variables among companies, before running the regression models we deflate each variable by a proper term of comparison: we deflate *pass_sent* and *future_sent* by the number of sentences forming the LS,

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obtaining two new dependent variables *mag_pass_sent* and *mag_future_sent* expressed in percentage; also, we deflate *pers_ref*, *key_fin*, *money_ref*, and *perc* by the number of words included in LS, obtaining four new dependent variables (*mag_pers_ref*, *mag_key_fin*, *mag_money_ref*, and *mag_perc*).

Table 4a presents the results of the multivariate analysis run with reference to those IM gimmicks supposed to be positively related with a negative performance (*mag_pass_sent*, and *mag_future_sent*), while Table 4b presents the results of the multivariate analysis run with reference to those IM gimmicks expected to be negatively related with a negative performance (*mag_pers_ref*, *mag_key_fin*, *mag_money_ref*, and *mag_perc*).

The magnitude of passive sentences in the LS (*mag_pass_sent*) seems not significantly associated with performance (Table 4a, Columns 1 and 2), while the magnitude of future-oriented sentences (*mag_future*) is negatively and significantly associated with the overall performance (*d_perf*) (Table 4a, Columns 3 and 4). Therefore, companies which do not meet both the thresholds of small positive ROA and ROE tend to be more focused on future perspectives compared to profitable firms. Such result is consistent with previous empirical evidence on the use of IM in the LS (Clathworthy and Jones, 2006).

	(1)	(2)	(3)	(4)
	mag_pass_sent	*mag_pass_sent*	*mag_future_sent*	*mag_future_sent*
d_roa	-2.8683		-1.9888	
	(2.6448)		(6.6382)	
d_perf		-3.2406		-12.6496**
		(2.2055)		(5.2534)
ls_lenght	0.2184	0.2815	0.6310	0.3252
	(0.6631)	(0.6409)	(1.6643)	(1.5267)
size	0.2372	0.1640	-1.4088	-1.0441
	(0.5356)	(0.5041)	(1.3442)	(1.2007)
industry	(omitted)	(omitted)	(omitted)	(omitted)
_cons	19.5402***	20.3115***	27.2734**	35.9198***
	(4.9796)	(4.9639)	(12.4983)	(11.8236)
N	52	52	52	52
R^2	0.2310	0.2481	0.0845	0.1939
F	1.4015	1.5396	0.4308	1.1222

Table 4a. *The relation between firm's performance and specific impression management practices (+)*

Standard errors in parentheses; * p<0.1, ** p<0.05, *** p<0.01

As for IM gimmicks supposed to be negatively associated with a negative performance, we do not find significant coefficients neither for the percentage of personal references (*mag_pers_ref*) (Table 4b, Columns 1 and 2), nor for the magnitude of key financial indicators (*mag_key_fin*) contained in the LS (Table 4b, Columns 3 and 4). Conversely, we find support to our expectations that unprofitable companies tend to skip providing details on their financial situation and overall economic trend in both monetary terms (*mag_money_ref*) and percentages (*mag_perc*). Indeed, as shown by Table 4b, Columns

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5-8, both such variables are positively and significantly related with operating performance proxied by the test variable *d_roa* (p<0.1 and p<0.01, respectively).

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
*mag_*	*pers_ref*	*pers_ref*	*key_fin*	*key_fin*	*money_ref*	*money_ref*	*perc*	*perc*
d_roa	-0.0190		0.0368		0.3675*		0.4701***	
	(0.0383)		(0.0290)		(0.2049)		(0.1744)	
d_perf		-0.0269		0.0127		0.2853*		0.1788
		(0.0321)		(0.0248)		(0.1738)		(0.1569)
ls_lenght	-0.0090	-0.0088	-0.0032	-0.0050	0.1269**	0.1144**	0.1468***	0.1246***
	(0.0096)	(0.0093)	(0.0073)	(0.0072)	(0.0514)	(0.0505)	(0.0437)	(0.0456)
size	0.0000	-0.0002	-0.0043	-0.0022	-0.0413	-0.0267	-0.0847**	-0.0586
	(0.0077)	(0.0073)	(0.0059)	(0.0057)	(0.0415)	(0.0397)	(0.0353)	(0.0359)
industry	(omitted)	(omitted)	(omitted)	(omitted)	(omitted)	(omitted)	(omitted)	(omitted)
_cons	0.0630	0.0724	0.0899*	0.1025*	0.2075	0.2099	0.2768	0.4251
	(0.0720)	(0.0722)	(0.0545)	(0.0559)	(0.3858)	(0.3912)	(0.3283)	(0.3531)
N	52	52	52	52	52	52	52	52
R^2	0.0952	0.1049	0.1654	0.1387	0.2978	0.2896	0.3497	0.2600
F	0.4911	0.5469	0.9250	0.7513	1.9790	1.9022	2.5092	1.6399

Table 4b. *The relation between firm's performance and specific impression management practices (-)*

Standard errors in parentheses; * p<0.1, ** p<0.05, *** p<0.01

Sensitivity analysis

To validate the results of our main regression models, we run two sensitivity tests modifying our dependent and test variables, alternatively.

Firstly, we construct the IM index without standardizing its components, but simply considering them in percentage and calculating the following sum:

im_index_perc = mag_pass_sent + mag_future_sent + (100–mag_pers_ref) + (100–mag_key_fin) + (100–mag_money_ref) + (100–mag_perc)

The main regression models run replacing the dependent variable *im_index* with *im_index_perc* show that *d_roa* is not significantly associated with IM practices, while *d_perf* is negatively and significantly associated with the latter (p<0.01). This last result supports our research hypothesis.

Secondly, we replace our test variables with a new variable proxying for companies operating performance. We calculate the median ROA for the companies in the sample and create a binary variable *d_median_roa* equal to 1 if the firm ROA is equal to or higher than the median level and 0 otherwise. Both *im_index* and *im_index_perc* result to be negatively and significantly associated with this performance variable (p<0.05), again confirming that companies with an unsatisfying performance are more prone to make use of IM gimmicks in their LS.

To summarize, both the additional tests and the sensitivity tests provide support to our research hypothesis.

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CONCLUSIONS

The LS is the most read part of the annual report (Bartlett and Chandler, 1997) and provides information that is used by investors to assess companies' performance and prospects (Smith and Taffler, 1995 and 2000). In spite of this, previous studies demonstrate that managers use LS opportunistically, providing disclosure that is biased as firms' writing style is contingent on financial performance. Our study contributes to this literature by showing that also Italian firms use LS as locus of IM strategies similarly to European firms and non-European firms (*e.g.* Hoogiemstra, 2010; Aerts, 1994 and 2005). Additionally, we add more generally to the IM literature by developing a multidimensional and comprehensive measure of disclosure bias based on six textual characteristics that previous studies consider symptomatic of IM strategies (Clathworthy and Jones, 2006).

Being a first exploratory study on IM in the Italian context, our research is not free from limitations. First of all, we are dealing with a small number of observations which could impact on the effectiveness of our regression models. However, we are already working to augment our observations including in the sample firms pertaining to different industry groups (*i.e.* the financials). Additionally, it would be important to assess the presence of IM strategies in other parts of the overall financial report, such as the Management Discussion and Analysis section, or in the Press Releases issued by the firms.

To conclude, the study has important implications as it sheds light on the fact that the users of LS should be quite sceptical when reading this document and be cautionary in shaping their expectation on firms' performance based on LS content (Kaplan *et al.*, 1990). In particular, investors and stakeholders willing to gain a complete picture of companies achievements should supplement the information provided in these letters with the other provided in other forms of corporate reporting.

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